RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P.O. Box 1759, La Jolla, California 92038
36 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

January 5, 1978 **LETTER 718**

Dec. 23, DJIA 829.87; PTI 796; A-D ratio –20.10
Dec. 30, DJIA 831.17; PTI 805; A-D ratio –19.94

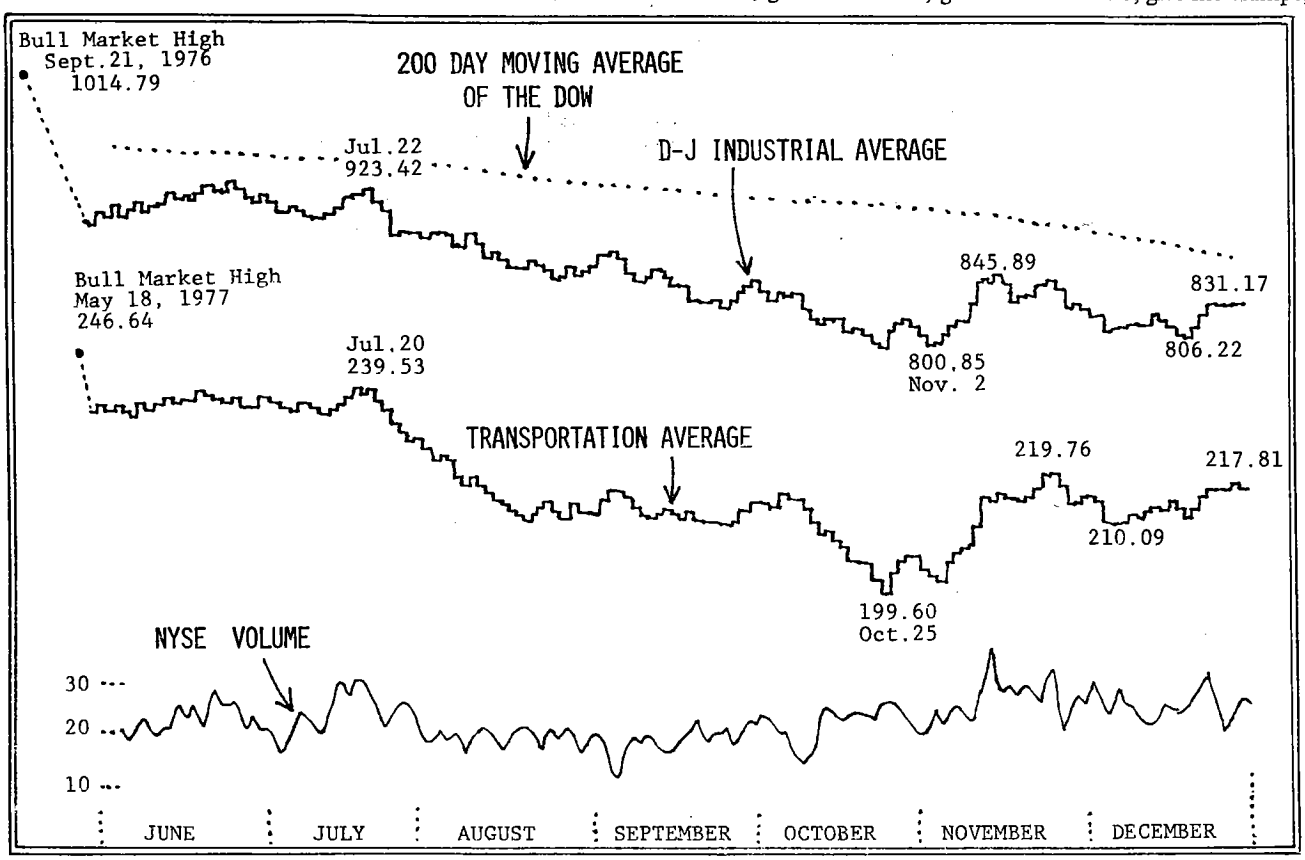
THE PICTURE: In the 16 months since September, 1976, the D-J Industrial Average has been in a protracted decline. During all that time, incredibly, the Dow has been able to mount only one rally, a rally of just over 5% (see chart below). This entire performance, in terms of persistence of decline and lack of rallying power, must go down as one of the most dismal performances in Wall Street history (going back to 1886).

In the face of this, many (if not most) analysts have been denouncing the Dow, insisting that "the Dow isn't the market," or pointing to the superior performance of the various unweighted or broader stock indices. Personally, I fully accepted the thesis that the Dow wasn't the perfect average back in the mid-1940's (when I first started studying the stock market). Over the years I've also observed that when the Dow is outperforming the rest of the market, the analysts point to the fact that the 30 Dow Industrials make up a huge percentage of the net value of the NYSE, and that the superior performance of the Dow should never be ignored. But when the Dow is down and out, and the rest of the market (as now) has tended to outperform the Dow, it is then that the Dow reaps the scorn and derision of Wall Street and the world.

As far as I'm concerned, I've learned never to ignore "the message" in the action of the Averages. I'm more interested in trying to decipher what "the Dow is telling me" than to prove that somehow the average action of 30 of America's greatest corporations "doesn't mean a thing." I've said it before, and I may as well repeat it. No other group of stocks in the world receive as much attention, as much analysis, as much probing and interviewing and examination and thought as the 30 Dow stocks. So when the opinion of the market is that they're worth less and less over a period of 16 months, I'm impressed and just a bit awed.

All of this is not to lose sight of the fact that we've been witnessing the longest and most dramatic divergence between price (the Dow) and breadth (the Advance-Decline Ratio) in Wall Street annals. What could it mean? My own guess is that many forces have militated against the big Dow stocks, not the least of which is that the institutions "owned so much of the Dow issues." And in their effort to diversify into other equities and into bonds, the Dow stocks have born the brunt of the selling.

But the fact is that since 1966 and more dramatically since 1973 the institutions and everyone else have had a horrible experience with stocks in general. First, stocks didn't move up (as they were supposed to) under inflation. Second, stocks became (increasingly) the target of liberal lawmakers and consumer-oriented "guardians." Third and most important, stocks on average fell apart during the 1966 to 1974 period. The result was a traumatic experience for the Wall Streeter, the fund manager and the Main Streeter. Their reaction was predictable, "Give me bonds, give me homes, give me real estate, give me stamps, coins,



land, antiques, anything but stocks!" And lo, we witnessed the great decline of the price/earnings ratio, the great slide in what people were willing to pay for stock earnings.

All of which brings us to today. "All right, Russell," you ask, "what do we do now?" And my answer is that we're now in the era of the "struggle for investment survival." There's **no sure area** any more. We must, from this point on, be absolutely open-minded to events. Those who are opinionated, those who are prejudiced, those who refuse to change their minds and actions, those who are trying to prove something, they are all headed for disaster, as I see it, over the coming years.

In my opinion, we are moving into very **difficult** and **fast-changing** times from here on. Some of the things investors now have to face are: (1) harsher Government laws, regulations and taxes, these because our Government is a mighty spender and has a never-ending need for new money. (2) The possibility of either an inflationary blow-off caused by a steadily rising money supply, or (3) ironically, a deflationary collapse, brought on by a weakening dollar and rising interest rates. (4) Excellent potential for world trouble set off by the bankruptcy of one or more "Less-Developed-Nations" or an economic cave-in brought on by a drastic slide in exports on the part of European nations.

These are only a few of the many possibilities that now face investors as a result of the new free market in world currencies, the huge new balance-of-payments deficits being generated by the US, and the constantly rising level of international debt, a rise that is upsetting the equilibrium of the Free World. As a result of all this I believe we as investors may be seeing **shorter and more violent** bull and bear markets (these probably within the context of longer overall bull and bear tidal movements). I believe that we as investors will also have to think in terms of "targets of opportunity," situations which may be interesting for three to six months, but perhaps seldom longer than a year.

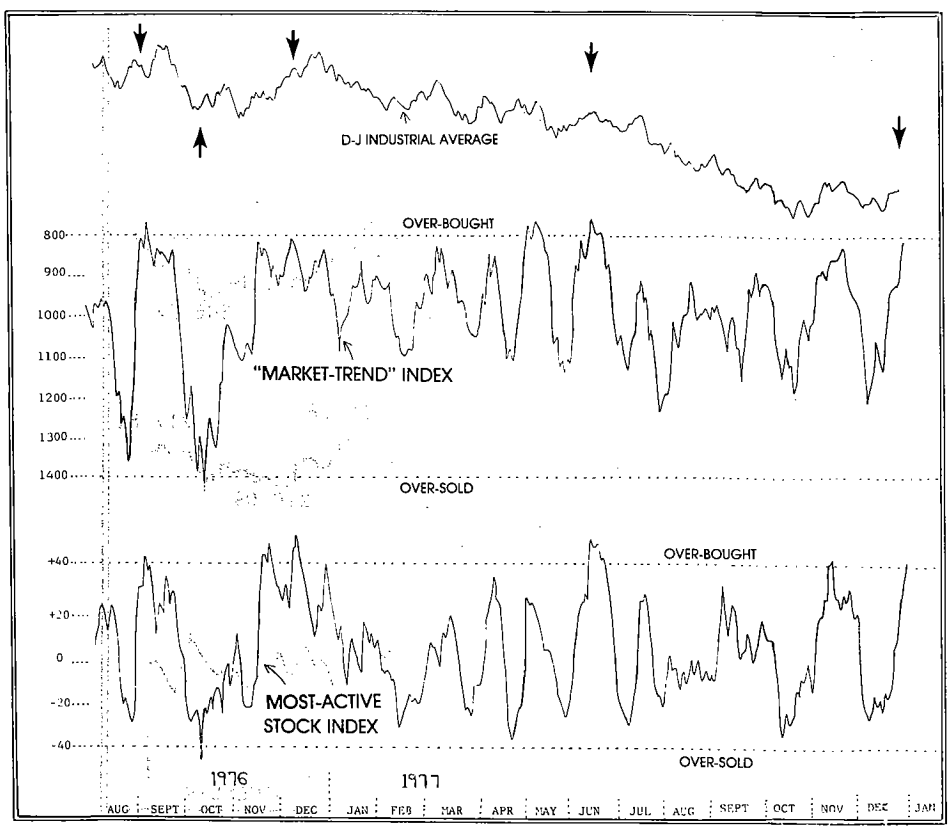
We will also find that we are basically "hanging on" (trying to stay even) as far as our investments are concerned, and I mean hanging on for perhaps extended periods of time. These will be periods where the man who **loses the least** will be the winner. There will be other periods, perhaps a six month or one year boom in the stock market (or some other market), which will allow us to garner substantial profits.

My guess is that the year 1977 represented a year when most people took some losses and a year when many people took substantial losses. I feel that my strategy of bonds (earlier in 1977) and then Treasury bills and gold (later in 1977) was a successful one under the circumstances. Those who bought bonds earlier (as suggested) and then sold them in late-1977 (as suggested) had to make money in bonds, both in terms of yield and appreciation. As this Letter is written, I assume that my readers are 80% to 90% in Treasury bills with the remainder in gold bullion or gold coins. This is the position that I believe is most advantageous at this time. Our next change, if my calculations and intuition and instincts are correct, will probably be into common stocks somewhere along in 1978. I can't say at this time where the ideal buying area will be, but I hope to **identify it** when we get there.

In the meantime, the bond market has been hit hard, the stock market is a disappointment, money rates are climbing, gold has turned firm, and I am counting my blessings.

CURRENT MARKET: The action since the November 11 Dow high of 845.89 has developed about as I indicated (in recent Letters) it might. Industrials retreated and twice "tested" the 806 area, while the Transport Average dropped back to bounce off the 210 level (see chart on page 1).

Then came the long-awaited "year-end rally," and it was a **disappointment.** Industrials rallied laboriously to 829.87 (Dec.23) while the Transports pushed to within a few points of their November peak of 219.76. And that's about where we find the Averages as the New Year begins.



In the last Letter I stated that we were watching two pair of points in the Averages. On the topside we are watching **845.89** Industrial and **219.76** Transport highs of November. On the bottom side we are watching the 800.45 Industrial low and the 199.60 Transport low (again refer to page 1 chart). A joint breaking of either of these dual points, I wrote, would point the way for the next major swing of the market.

As of this writing, the Averages have not seen fit to give us their final verdict. But one most interesting situation has developed. As seen on the page 2 chart, my two "over-bought, over-sold" indicators are *now* registering an **over-bought condition** for this market for the first time in 7 months (or since last June). Thus, as you can see on the chart, my indicators have given their third over-bought danger signal since late 1976—without having provided a single over-sold signal in all that time!

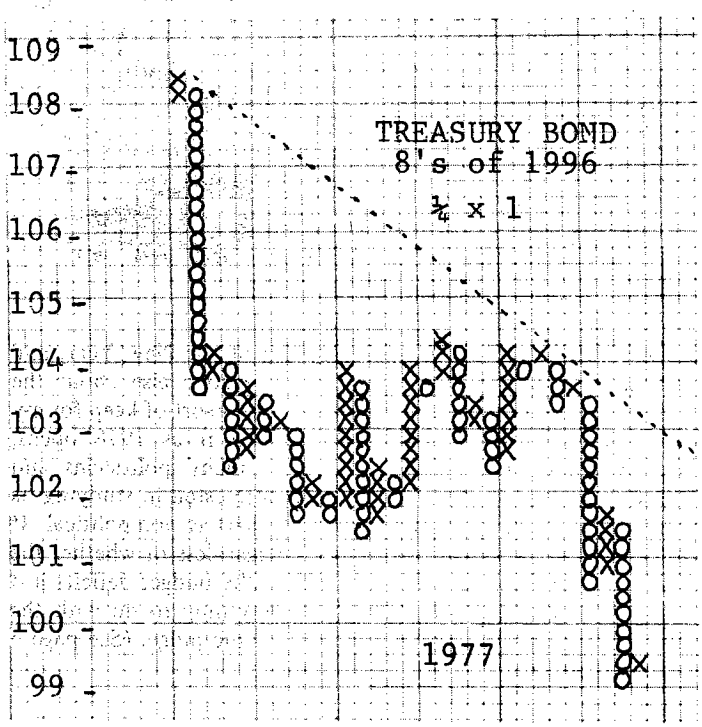
The amazing thing about these three over-bought signals (identified by down-arrow on the chart) is that they were generated with so little rallying action in the Averages. It is as though the Averages decline heavily from each

over-bought situation, but they rally only feebly from each over-sold situation. This, to my mind, is an ominous phenomenon and one which justifies our sideline stance. It is the kind of action that I feel is characteristic of a bear market. The only question remaining is this: will the "rest of the market"(as measured by the A-D ratio) decline here if the Dow heads down again. My feeling is that it will.

I obviously can't tell whether the market is going to greet the opening week of 1978 with a rally or not, but any rally will just turn my indicators **from over-bought to "super over-bought."** Therefore, **stay on the sidelines.** Don't be sucked into this market. Let's sit tight until we get a classic over-sold bottom. I think we're going to see one this year–it should be "a biggie," and it should come in the first quarter or half.

OMENS: It isn't often that a single chart can tell the story, but I believe this chart of the bellwether (and very typical) Treasury bond, the 8 of 1996, is giving us "the word." The word (as I've been warning about for months) is that the money markets are buckling. Money runs the markets, money runs the economy, and money makes men run. Right now, the Fed, President Carter, Treasury Secretary Blumenthal, the liberal economists, they're all trying to talk down the money rates. But it's not working. The pressure of the mounting US budget deficits, the pressure of US trade deficits, the pressure of the weakening dollar, the pressure of sky-rocketing consumer and corporate and municipal and city loans, they're proving to be too much for the money markets. The result is that we're seeing the early beginnings of "the big squeeze."

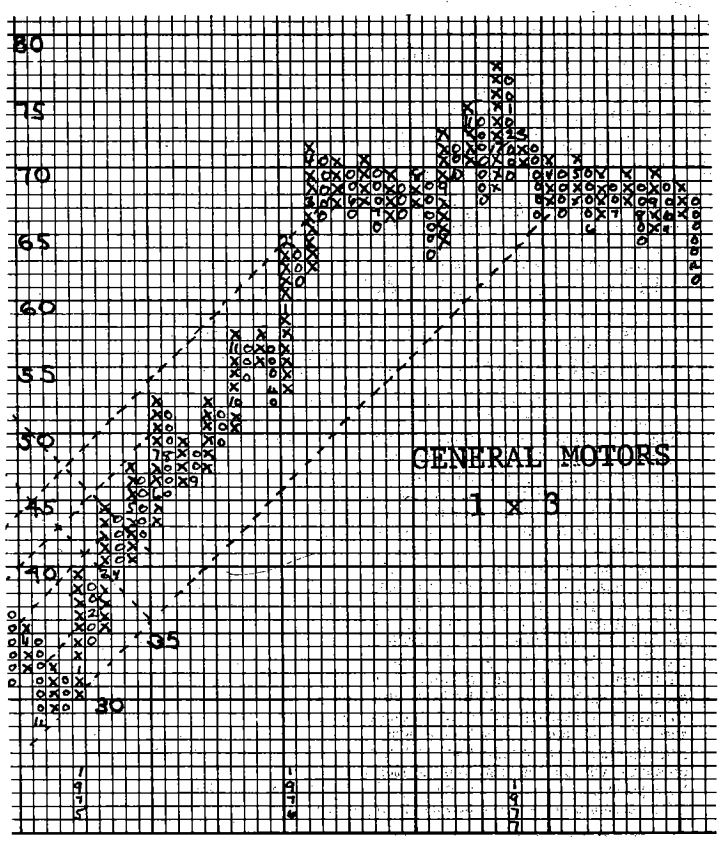
I included this chart in Letter 716, warning at the time that the Treasury bonds were giving a major **"sell signal" for the money markets.** I urged readers again to get out of all bonds and to move into Treasury bills, the shortest-term obligation of the US Government. Since Letter 716 the bond market and the money markets in general have headed down. Interest rates have pushed higher. And the 8's of 1996 (pictured here) have broken sharply below par (under 100) to yield over 8% to maturity.



That kind of action, as my readers know only too well, is heavy medicine for the stock market, heavy indeed. In fact, I'd say that in my experience there is no more negative background for stocks than a bond market that has topped out and is moving downhill. And that is exactly what we have now.

I'm beginning this Letter in a rather unorthodox way, and I might as well continue in that vein. The second chart I want to show is also one that I consider critical. It is a point and figure chart of General Motors. Every box on the chart represents 1 point–the vertical rows of X's denote rallies, vertical rows of O's represent declines (chart from *Chartcraft*, Larchmont, NY). Readers may feel that I'm dwelling too much on GM, but I don't think so. This stock is the dominant entity in one of the major industries in the nation, an industry which directly or indirectly employs one out of every seven workers in the nation. At any rate, what we see here is an awesome top on GM, a top that has been completed by a definitive break by GM down to the 62 level.

Now I don't pretend to know what has caused this spectacular top and break. I can guess that GM is going to move into troubled seas in 1978, seas dominated by falling sales and profits. From our standpoint it doesn't much matter "why" it's happening. What does matter is that GM has given a major bearish signal. GM has fallen out of a top so large that it wouldn't surprise me to see the stock ultimately test its bear market low of 1974.



1978: My own feeling is that the operative phrase for 1978 (and probably 1979) is going to be the expression, "out of control." And when I say out of control, I'm talking about budgets, deficits, spending, governmental stupidities, Washington impotence.

The new statistics are starting to emerge, and they are hardly encouraging. For instance, the budget deficits (national) for the first two months of the new fiscal year (October and November)

are $29.3 billion against last year's $23.9. That's an increase of 15% so far this year, and we're just beginning. Add 15% to Carter's $58 billion estimate for the new deficit and you get about $66 billion. Then add $25 billion, based on the proposed tax cut and you could end up with around $80-90 billion. And brother, if that's the kind of deficit we come up with then the nation's finances are indeed out of control.

* *

California's Senator Sam Hayakawa may have put it all into perspective as he commented on his recent placement on the Senate Budget Committee. *"I don't understand money,"* he said, *I have the greatest difficulty balancing my own checkbook. But it's not really that bad,"* he added. *"All you have to do is know how to add. You don't even have to know subtraction. When we say 1.0, that means $1 billion. When we say .1., that means $100 million–and that's the smallest figure we ever deal with... An item is 2.5.....Sombody says, 'Let's raise it to 3.7. Everybody in favor? OK.' So in five minutes we have disposed of 2 billion bucks–2 billion not 2 million. I never realized it could be so easy."*

* *

To get serious again, the US **trade** deficits are running around $2 to $3 billion a month, and I don't see them getting any better. One reason is that I don't see this nation cutting back on oil consumption (specifically foreign oil consumption), and that means that our **imports** are going to remain high. As far as exports are concerned, I call readers' attentions to the accompanying news clips that suggest that our trading partners are not going to be big buyers of US goods in 1978. And in case you need further proof, I include this chart (from Cleveland Trust) showing that industrial production (arrows) in every major developed country in the Free World is turning down.

1978 ECONOMIC FORECAST

Industrialized Nations' Outlook Called Bleak

PARIS (AP) — The non-Communist industrialized nations will have a bleak economic year in 1978, frustrated by sluggish growth and rising unemployment, a watchdog international economic organization predicted yesterday.

In its semiannual forecast, the Organization for Economic Cooperation and Development said its 24 member nations will show an overall growth rate of only 3.5 percent next year and most will suffer increased joblessness, continuing balance of payments deficits and increasing domestic pressures for protectionist trade policies.

The organization warned the United States, Japan and West Germany that too little economic stimulus next year will generate more unemployment, while too much will spark another dangerous round of world inflation.

However, it denied the industrialized world was trapped in a "damned-if-you-do, damned-if-you-don't" dilemma of either unemployment or inflation.

NO 'CATCH-22'

"This is not a Catch-22 situation," said John Fay of Britain, director of the organization's secretariat. "If the right things are done, they will work." Catch-22, from a 1961 novel of that name by Joseph Heller, means a regulation that makes one a victim of its provisions no matter what one does.

At a news conference Fay urged the United States, Japan and West Germany — "The Big Three" industrial nations — to move quickly to stimulate their economies and not bow to nationalist pressures for protectionist measures or other restraints on free trade.

On the brighter side, Fay said the secretariat was encouraged by Japan's recent improvement in industrial production and by the "significant improvement" in the balance of payments positions of Italy, France, Britain, Finland and Australia.

He also said the recent decision by oil-producing nations not to raise the price of oil was "some cause of satisfaction" for the industrialized nations.

DOLLAR SLIPPAGE

Regarding the United States, Fay said the slippage of the dollar on international money markets was "worrying" and applauded recent steps by the Carter administration to bolster the dollar.

Fay said the U.S. balance of payments deficit, which was termed a "striking development" by the report, was not caused by oil im-

FINANCIAL NEWS

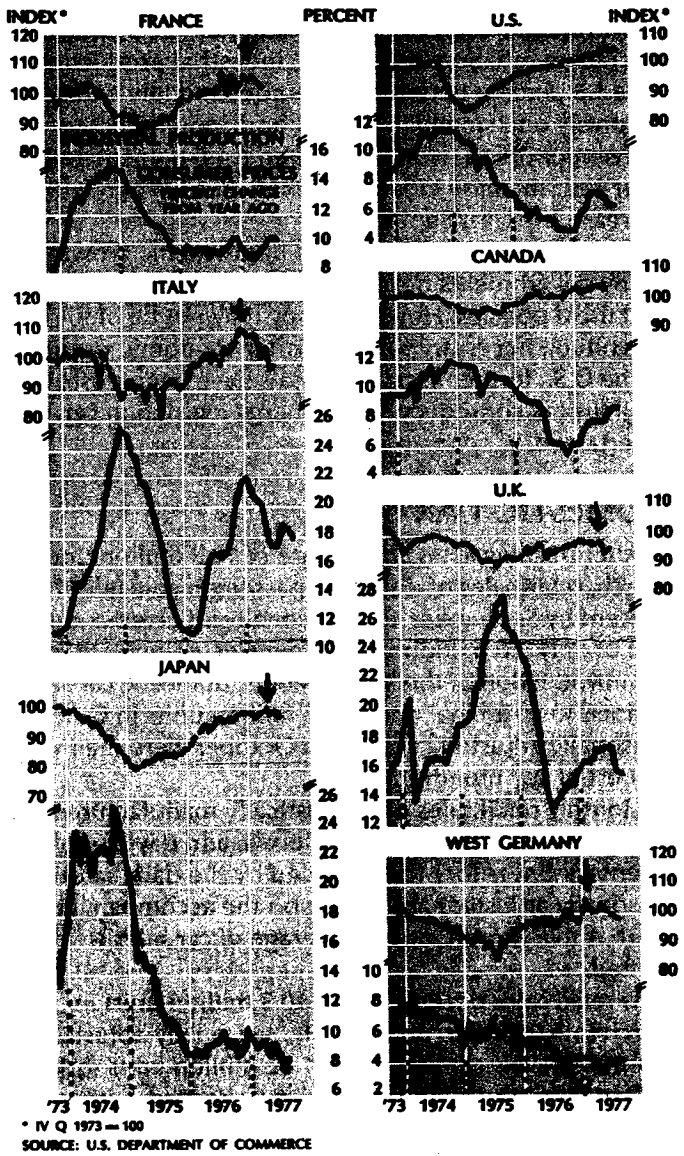
Economic Woes Seen For Canada

PARIS (UPI) — The Canadian economy is going to face sluggish growth, low demand for consumer goods and a possible further rise in unemployment, an authori-

controls next April, "seem unlikely to improve overall growth performance very much during 1978," the report said.

I've asked myself, as I wrote this section, "Russell, are you 'flipping out'? Are you becoming obsessed with debt? Are you losing your perspective? And my answer is that I really don't think so. I believe that the US is nearing the point of no return on debt, the point wherein we are sunk if we create more debt and in trouble if we pull in our horns and reduce the debt (by cutting spending and toughing it out through the accompanying depression).

INDUSTRIAL PRODUCTION AND CONSUMER PRICES



* IV Q 1973 = 100
SOURCE: U.S. DEPARTMENT OF COMMERCE

At any rate, since this is the beginning of the New Year, and everyone is lying to themselves and everyone else about the budget, I want to include a little chart that I sort of keep for my own amusement. I've decided to publish it as 1978 opens, because among my subscribers I have many politicians and Government leaders, and they may be interested in studying its implications. And mark this well–this chart is non-political. It says, "a curse on both your houses." Regardless of whether the Democrats or Republicans are in office, the budget deficits just grow. Does the mass of deficits have anything to do with the 13-year stall by the Dow? I'll let you be the judge. (See page 5 for chart).

While I'm talking about debt, it might be interesting to comment on the *current new debt mania*. It's called mortgaging the paper profits on your home. What's happening is this. According to the latest figures, the inflation appreciation in single-family dwellings in the US is now running about $62.2 billion a year. This paper "profit" represents about the only profit that the American public now possesses.

So what's happening? The public is running out and taking second mortgages (they call them second trust deeds in California) on their homes, based on inflation appreciation. The new mortgages written on this paper appreciation are running about $60 billion a year! In other words, the public is now borrowing on the paper profits on its homes.

To my mind, this is economic dynamite. It's margining paper profits. If, one fine day, housing prices turn down, if the nation starts deflating, these loans will collapse, since there will be negative equity value in the second mortgages. At that time, many Americans will be tempted to "walk away" from their homes. After all, who will want to be paying say $80 thousand worth of mortgage on a house worth maybe $50 thousand? It could happen. Remember that there have been many inflations in world history–but none have lasted forever.

NOTES & QUOTES: Stamp dealer Myron Kaller (PO Box 665 Hicksville, NY 11802) (who recently purchased the famed "Princeton inverted block" of early US Airmails for $210,000) writes: *"We predict that within the next decade, there will be an international exchange (similar to a stock exchange) for rare stamps. The signs are beginning to surface. Rare stamps are becoming a recognized 'store of value' all over the world."* I agree, but stamps are like any other collectible, they must be purchased with great care and expertise.

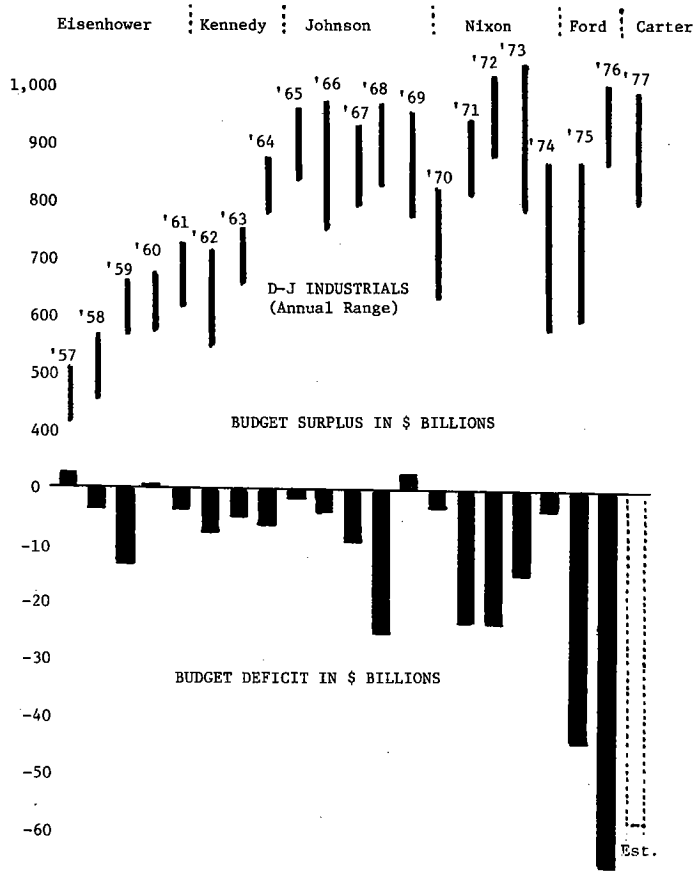
Leon Cooperman (*Financial World* year-end roundup) notes that *". . . in the early 1960's, the P/E ratio on the major averages was . . . about 20 times earnings, which means that it cost business about 5% after taxes to raise capital. The long-term bond rate was about 4%. Today the P/E multiple in the market is between 7 and 8 times, which means that the cost of equity money is about 13% after taxes, long-term bond rates are near 8¼ to 8½%. Basically, this means that we've had more than a doubling of the cost of debt capital. Yet. . . the rate of return on equity has risen from only about 11½% to 13%."*

In other words, it costs about **twice as much** to raise capital today as it did during the early 1960's. Yet your return on capital is little better today. And that's why corporations are merging and devouring each other. It's cheaper and more profitable to take over the other guy than to expand your own facilities.

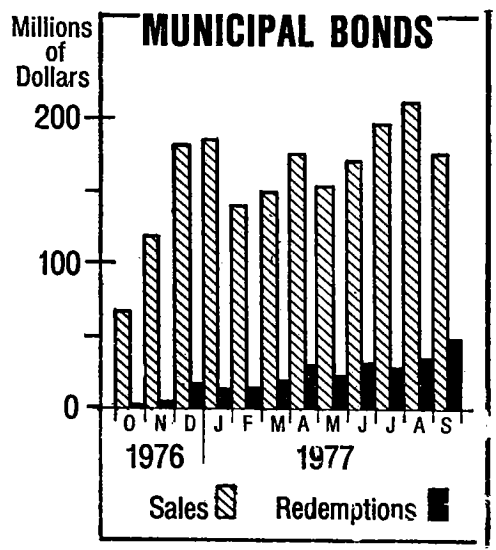
* *

There's only one "hot" area in the mutual fund business today, and that's the Municipal Bond funds. I was very early in recommending these funds, but more recently I recommended that my subscribers sell 'em out and put the money into Treasury bills. Why did I say "sell"? First, I felt that the bond market was heading down (it is). Second, I don't think the Muni bonds are going into strong hands, as illustrated by this chart. Note the huge totals of purchases over sales by the public since 1976, when these funds first became legal.

Third, Muni bond yields as a percentage of taxable bond yields are now about as low as anything seen in a generation (or since



the Korean War). In other words, in their eagerness to escape taxes, people are paying too high a premium (at this point) for Muni's. Finally, the Muni market is very thin. It's always a buyers market. If the funds have to sell any large amount of Muni's, we could see a very sharp slide in Muni prices. And that's it in this area.



* *

Subscribers may wonder what I think of the Fed's new Mr. Miller, and what I conclude from the heave-ho given Arthur Burns. Simple, our arrogant President wants nothing but "yes men" around him, and Burns didn't fit that mold. Miller is an "expansionist" and he presided over a conglomerate built on expansionary thinking, takeovers, mergers and boom economics. Don't expect him to defend the dollar. He'll simply do what Jimmy Carter wants him to do.

GOLD: On January 3 gold "broke out" on my charts, and I offer two views below. The Point & Figure chart shows gold moving above the recent 168.15 peak. My guess (and this is only a guess) is that gold could be heading for the mid-170 –180 area, there to consolidate. If so, we would have a massive "head-and-shoulders" bottom all within another even larger head-and shoulders pattern. The best part of the new breakout is that it suggests tremendous support in the 154-156 area. And this, to my mind, is a very big plus since it would seem to *limit the risk* in holding gold.

On the chart (bottom of page) I show gold with two short-term moving averages, both of which are now hurdled. The heavy dashed line at the bottom of the chart is a 52-week moving average of gold, which I regard as a "primary trend indicator" of the yellow metal. Obviously, the primary trend continues up.

What do new readers and non-holders of gold do here? I don't know, but I would say, buy a small amount, something to at least get started with. Gold has now moved up 13 dollars since our recent ideal correction bottom, and it's always a bit risky chasing the price movement.

Subscribers should get two concepts firmly fixed in mind regarding gold. I have advocated holding 10% to 20% of assets in gold coins (or bullion) not for the purpose of "making a killing," but as an **insurance policy** against the possibility of an inflationary explosion or a panic deflation slump. I don't want anyone buying gold and then waiting anxiously for gold to roar to $300 or $500 an ounce. As friend Harry Schultz just observed, if we're waiting for gold to sky-rocket we are (by implication) also waiting for the dollar to totally collapse. If that happens, it's all over anyway. So don't be too eager for the big explosion in the yellow metal. Just treat your gold as insurance against a rainy day.

Next, with all currencies now floating, we must remember that they are actually floating in terms of gold. For instance, during the past year the dollar has slumped in terms of gold, while the Swiss franc has declined gently against gold. The yen and the mark have also declined gently against gold. Nevertheless, the fact is that all paper currencies have declined against gold over the past year, and my guess is that as the world economies struggle with each other for export markets, we will see a continued downward float of all paper currencies against gold.

What happens, we ask, if the yen, the mark and the Swiss franc suddenly start to rally against the dollar? One thing that could happen is that a good deal of the so-called hard currencies could switch into gold. In that case we could see both gold and the dollar rise against the hard currencies, with gold outpacing the dollar on the upside.

Another interesting factor in the 1978 gold equation is that this year ushers in the end of the Central Banks' gentleman's agreement not to buy gold. The Central Banks are now free to purchase gold, and during early 1978 we may see such nations as Japan and Germany start to build up their gold reserves.

LATE NOTES: Yale Hirsch (Stock Market Almanac) watches the last four trading days of the year and the first two trading days of the new year. He terms these 6 days "the Santa Claus rally." The Average of these 6 days over the past two decades has been a plus 1.82% on the S&P 500 Composite (equal today to about 15 points on the Dow). When the Santa Claus rally is sub-standard, it usually indicates a poor January and a poor year. So far, the Santa Claus rally is turning out to be, as my teen-age daughter would put it, "a bummer."

If the market continues to head down, watch **806.22**, the December low for the Dow. When the December low is broken during the opening months of the new year–well, "it ain't a good sign." But the critical points are still **800.45** (Industrials) and **199.60** (Transports).

Final note: the real consensus today is that business and corporate profits are heading up, regardless of what Wall Street does. If you believe in contrary opinion . . . .

NEXT MAILING: January 18